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SUBJECT: MPs Examine Banking Remuneration As Prime Minister
Announces Measures To End "One-Way Bet" Culture

¶1. (U) Banking remuneration structures have become hotly debated in the UK following the part-nationalization of some of the country's largest banks. RBS in particular caused a media outcry when it announced it planned to pay GBP 1 billion in bonuses for 2008, despite share prices falling 90 percent, having to write-off GBP 20 billion of assets, predicting a GBP 8 billion loss, laying off 2,300 staff and being 70 percent owned by the taxpayer. PM Gordon Brown faced increased pressure to act on the banking system's bonus culture following President Obama's plan to cap senior bankers' pay, which was widely praised in the UK. The Conservatives are drawing up measures to curb City excess and have not ruled out capping bonuses. A Tory party spokesman said HMG owns these banks and should ensure executive pay is reasonable.

¶2. (U) Richard Lambert, director general of the Confederation of British Industry, singled out the bonus culture as one of the central factors in creating the financial problems now engulfing the banking sector. He said bonuses rewarded bankers for success but failed to penalize failure. He accused investment bankers of being cavalier in their attitude to risk and said there is a serious misalignment between the interests of managers and shareholders. Hector Sants, Chief Executive of the Financial Services Authority (FSA), echoed Lambert's critique of remuneration structures in a letter to the bank chief executives as early as October 2008. He said a major contributor to the current crisis was the bonus driven culture, which led to short-term decision making and high risk taking.

¶3. (U) As part of its enquiry into the banking crisis, the House of Commons' Treasury Committee held hearings with the heads of the UK's largest banks February 10-11 that examined how far remuneration policies contributed to the financial crisis by rewarding the "wrong kind" of risk taking. The Committee charged the bank chiefs with paying insufficient regard to the need to secure long-term shareholder value. Chairman John McFall said the former Deputy Prime Minister, John Prescott, presented him with 23,000 signatures prior to the hearings - all requesting that bonuses not be paid out by banks in receipt of public money. Andy Hornby, former Chief Executive of HBOS, acknowledged that executive compensation should be closely tied to long-term performance. Sir Tom McKillop, former Chairman of RBS, said a fundamental look at remuneration policies should happen across the board in a coherent, consistent way to avoid the risk of personnel arbitrage. Despite a general acceptance of the need for reform, Sir Fred Goodwin, former Chief Executive of RBS, said it is very difficult for an individual institution to make a change unilaterally. He said it's a highly competitive market and many of the remuneration practices imported from the U.S. have become part of the UK banking culture.

¶4. (U) HMG must take action to end the "one-way bet culture" that encouraged banks to make reckless decisions, PM Gordon Brown wrote in an article in The Times February 18. He outlined four principles that will apply to executive compensation in the part-nationalized banks going forward. He said there will be no reward for failure - people associated with losses will not be entitled to receive a bonus. Second, no bonuses will be issued in the future unless they

are based on long-term sustainable performance. Third, clawback clauses will be introduced and used if performance is not sustained or employees leave before the consequences of their activities fully feed through. Finally, the FSA will take into account a bank's pay and bonus structures when supervising a bank. On February 9, Chancellor Darling announced an independent review of corporate governance. It will be led by the former financial services regulator, Sir David Walker, and will examine measures to improve the corporate governance of UK banks, including the incentives to manage risk in remuneration policies.

15. (SBU) "Lots of politics" surrounds the issue of executive remuneration, according to Sally Scutt, Deputy Chief Executive of the British Bankers' Association (BBA). She told us that HMG is looking for people to blame for the financial crisis in the run-up to the next general election and sees that it can take popular action on the banking bonus culture. She said HMG needs to find a proper form of corporate governance that aligns remuneration with a bank's risk appetite. She was critical of clawbacks which would be technically difficult and would have big tax implications for banks operating internationally. She said the Financial Services Authority (FSA) started a project last year to examine good and bad remuneration practices with a small number of banks and expects its initial findings in March, before it starts a broader consultation. Scutt expects the FSA to roll remuneration into its Arrow Risk Assessment Process, with supervisors established to monitor compensation structures within banks. She cautioned that banking talent could flow to the unregulated sector, including hedge funds and off-shore centers, if banking remuneration structures become too restrictive.

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